



Appeal of Union Carbide Corporation

Two questions are presented in this appeal: (1) whether respondent, in computing appellant's apportionment formula 'sales factor, properly applied the "throw back" rule to certain sales of goods shipped from California to customers in foreign countries, thereby attributing those sales to California; and (2) whether respondent properly excluded from the property factor government-owned property which was used by appellant in its unitary business.

Appellant is a New York corporation with its principal office in New York City. It is a large diversified company whose activities include research and development and the production of chemicals, plastics, gases, gas-related products, metals, carbons, consumer products, and nuclear products. During the appeal years, appellant had subsidiaries operating in a number of foreign countries. Appellant was engaged in a single unitary business with one or more of its subsidiaries and filed its **California franchise** tax returns **using** combined report and apportionment formula procedures.

Appellant, since it **was engaged** in a single unitary business, was subject to the apportionment and allocation provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), found in sections 25120 through 25139 of the Revenue and Taxation Code, in determining its income attributable to and taxable by California. (Rev. & Tax. Code, § 25101; Cal. Admin. Code, tit. 18, reg. 25101, subd. (f).) Under UDITPA, a taxpayer's income attributable to this state is determined by multiplying its business income by a fraction (commonly called the apportionment formula), the numerator of which is the **property factor** plus the payroll factor plus the sales factor, and the **denominator** of which is three. (Rev. & Tax. Code, § 25128.) The property, payroll, and sales factors are fractions, the denominators of which are composed of the taxpayer's worldwide property values, payroll, and sales,, respectively,, **and the** numerators of which are **composed** of the taxpayer's California property values, payroll, and sales, respectively. (Rev. & Tax. Code, §§ 25129, 25132, 25134.) It is **the** value of the numerator of appellant's sales, factor and the value of the denominator of appellant's property factor **which** are at issue in this appeal. For **ease** of discussion, each of these factors will be discussed separately..

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Sales Factor

Appellant. **itself** 'operated solely in the United States. However, some of its subsidiaries **apparently operated** in foreign countries. During the appeal years, appellant made variou's sales to customers in foreign countries, shipping the goods to them from this state. On its franchise tax return for those years, appellant did not include these sales as California sales in the numerator of its sales factor.

On audit, respondent determined that the sales to foreign customers should have been "thrown back" to California and included in the numerator of appellant's sales factor. It adjusted the sales factor accordingly and issued proposed assessments reflecting the adjustments.

Sales of tangible personal property are ordinarily assigned to the state of the destination of the goods (the destination rule). (Rev. & Tax. Code, § 25135, subd. (a).) **However**, such sales are assigned to this state and **includible** in the numerator of the sales factor if:

The property is shipped 'from an office, store, warehouse, factory, or other place of storage in this state **and** (1) the purchaser is the United States government or (2) the taxpayer is not taxable in **the** state of the purchaser.

(Rev. & Tax. Code, § 25135, subd. (b).)

Under this "throw back" rule sales are included in the numerator of the sales factor for the jurisdiction from which the goods were shipped rather than being assigned to the jurisdiction of destination. Respondent has applied the throw back rule to the sales in question, but appellant believes that the destination rule should be applied. **Which** of these rules applies depends on whether or not the taxpayer is taxable in the state of the purchaser. If taxable in the state of the purchaser, the destination rule must be applied; if not, the throw back rule applies.

Under the UDITPA provisions, the term "state" includes "any foreign country or political subdivision **thereof**." (Rev. & Tax. Code, § 25120, subd. (f).) Revenue and Taxation Code section 25122 provides that a taxpayer is taxable in **another** state if:

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(a) in that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Appellant has stated that, because of tax treaties, it was exempt from filing tax returns in foreign countries. Therefore, in order for the destination rule to be applicable, it must be shown that the foreign countries to which the goods were shipped had jurisdiction to tax, even though they did not actually impose a tax. (Rev. & Tax. Code, § 25122; subd. (b).)

Regulation 25122, subdivision (c), provides in part:

In the case of any "state," as defined in Section 25120(f), other than a state of the United States or political subdivision of such state, the determination of whether such "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state." If jurisdiction is otherwise present, such "state" is not considered as without jurisdiction by reason of the provisions of a treaty between that state and the United States.

(Cal. Admin. Code, tit. 18, reg. 25122, subd. (c) (arts. 2, 2.5).)

The jurisdictional standard imposed by the due process clause of the Fourteenth Amendment for state taxation of income from interstate transactions consists of two requirements: "a 'minimal connection' or 'nexus' between the interstate activities and the taxing State and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" (Exxon Corporation v. Wisconsin Dept. of Revenue, 447 U.S. 207, 219-220 [65 L.Ed.2d 66] (1980), quoting Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 436, 437 [63 L.Ed.2d 510] (1980).) Only the "nexus" requirement has been addressed by the parties in this appeal.

Appellant itself did not operate or have any presence in the destination countries. It argues, however, that it "has a presence in the foreign jurisdictions"

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through its subsidiaries (App. Br. at 4.) and that "through the operations of [its] subsidiary companies in the foreign countries" there is "sufficient nexus for the assignment of such sales under the usual 'destination' rule." (App. Reply Br. at 5.) Respondent argues that "[a]ppellant's position is comprised solely of conclusionary statements totally lacking in foundation." (Resp. Br. at 9.) It also contends that, even if foreign taxable nexus of the subsidiaries were shown, appellant's position is wrong because it is appellant itself which must have taxable nexus in the foreign countries in order to escape the throw back rule.

We must agree with respondent's first argument. Appellant's statements are mere conclusions of law, and absolutely no evidence has been presented to 'show what the subsidiary companies did or had in foreign countries which might establish taxable nexus. This situation is in contrast to that of the Appeal of Dresser Industries, Inc., Opinion on Petition for Rehearing, decided by this board on October 26, 1983, where we found that foreign countries to which goods were shipped had jurisdiction to tax Dresser because of nexus created by the sales activities of Dresser's subsidiaries on its behalf. In Dresser, the nexus-creating activities of the foreign subsidiaries were established in the record. In this appeal, appellant has presented no evidence at all to show that either it or its subsidiaries had taxable nexus in any foreign country. Because appellant has not shown that the foreign countries of destination had jurisdiction to subject it to a net income tax, under any legal theory, respondent's use of the throw back rule **must be** sustained. Having reached this conclusion, we need not consider respondent's second argument.

Property Factor,

Appellant was involved with the **Manhattan** Project during World War II and assisted **in the** development of a process to separate and enrich uranium isotopes. It also assisted in the design and construction of the first nuclear gas-separation plant and, upon its completion in 1943, began operating the plant under a contract with the federal government. The scope of the original contract has been expanded over the years, and, during the appeal years, appellant managed and operated four nuclear facilities in Kentucky and Tennessee.

Under its contract with the government, appellant was responsible for the full management, operation, and maintenance of the facilities and **provided** all

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necessary services, such as **purchasing**, personnel, and accounting. **Appellant's technical responsibilities** were the production- and **separation of fissionable** materials, the production of nuclear devices, and research and development. All products were produced for the federal government. The Atomic Energy Commission provided general direction over programs, and, in the absence of applicable directions and instructions, appellant was to use its best judgment, skill, and care in performing the contract.

Appellant provided the described services for the government under a "cost plus fixed fee" contract. For the years in question, the reimbursed costs and fixed fees were:

	<u>1971</u>	<u>1972</u>	<u>1973</u>
Costs	\$341,900,000	\$363,381,000	\$397,584,000
Fee	3,700,000	3,700,000	3,700,000
Total	<u>\$345,600,000</u>	<u>\$367,081,000</u>	<u>\$401,284,000</u>

Appellant did not, and could not, own these nuclear facilities which it used, and no rent was paid for its use of the facilities. It did, however, have exclusive use of the facilities, materials, and equipment.

In appellant's computation of its property factor for the income years 1971, 1972, and 1973, it included in the denominator a value for the **government-owned nuclear facilities.** Respondent determined that no value should have been included for this property and adjusted the property factor accordingly. Before discussing the arguments of the parties, a review of the statutes and regulations involved is necessary.,

Revenue and Taxation Code section 25129
provides:

The property **factor** is a fraction, the numerator of which is the average **value** of the taxpayer's real and tangible personal property owned or rented and used **in this** state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned **or** rented and used during the income year.

Section 25130 of the Revenue and Taxation Code, describes how property is to be valued for purposes of section 25129.

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Revenue and Taxation Code section 25137 provides:

If the allocation. and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity **in** this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any **part of** the taxpayer's business activity, if reasonable:

- (a) Separate accounting;
- (b) The exclusion of any one or more of the factors;
- (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) The employment of any other method to effectuate an equitable allocation **and** apportionment of the taxpayer's income.

Pursuant to this section; respondent has required certain taxpayers to use non-standard formulas or factors and has promulgated regulations setting forth the procedures to be used by those taxpayers. (Cal. Admin. Code, tit. 18, reg. 25137 (art. **2.5**).)

After UDITPA was adopted in 1966, the Franchise Tax Board issued an explanation of the new act titled Comments Regarding **Application** of the Uniform Division of Income for Tax Purposes Act (hereinafter "Comments"). (Cal. Tax Rep. (CCH) ¶ 203-548 (1967) (1966-1971 Transfer Binder).) Regarding section 25130, the Comments provided, in part:

If government owned property is used rent free, . . . a reasonable rental rate will be established so as to effectuate an equitable apportionment of the taxpayer's income.

Later, a regulation was adopted under section 25130, which stated in **part**:

If property is used at no charge or rented for a nominal rate, the property shall be included in the property factor on the basis of a reasonable market rental rate.

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(Cal. Admin. Code, tit. 18, reg. 25130, subd. (b)(1) (art. 2).)

New regulations under **UDITPA** were subsequently adopted, applicable for income years **beginning after** December 31, 1972. In this set of regulations, regulation 25137 sets forth **special rules** for the property factor, one of which states:

If property owned by others is used by the taxpayer **at** no charge or rented **by the** taxpayer for a nominal rate, the net annual rental rate for such property **shall be** determined on the basis of a reasonable market rental rate for such property.

(Cal. Admin. Code, tit. 18, reg. 25137, subd. (b)(1)(B) (art. 2.5).)

Respondent contends that, under section 25129, supra, only property that is owned or rented by the taxpayer may be included in the property factor. Because there is no provision in the standard formula for inclusion of property which is not owned or rented **by the** taxpayer, respondent argues that appellant must show that it is entitled, under section 25137, supra, to use a special apportionment method. It points out that this board has held that the party seeking **relief under** section 25137 bears the burden of proving that **exceptional** circumstances exist which justify application of that section.' (E.g., Appeal of The O.K. Earl Corporation, Cal. St. Bd. of Equal., **April 6, 1977**; Appeal of Donald M. Drake Co., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.) Appellant, it contends, has not shown such exceptional circumstances and thus must use the standard formula which would not include any value in the property factor for the government-owned nuclear facilities.

Appellant, however, states that it is not seeking relief from the standard **UDITPA** formula, but is requesting that respondent apply its **own** regulation 25137, subdivision (b)(1)(B), supra, **in** computing **the property** factor of the apportionment formula. For the reasons set forth below, we hold that respondent must apply its own regulation and include in the property factor a value for the **government-owned** nuclear facilities.

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The federal courts have had a number of occasions to **consider** whether regulations of the Treasury Department are binding on that agency. The consensus of these courts has been that Treasury regulations, unless they are invalid, are as binding on the government as they are on the taxpayer. (E.g., Zuchman v. United States, 524 F.2d 729, 739 (Ct. Cl. 1975); Petroleum Heat and Power Co. v. United States, 405 F.2d 1300, 1306 (Ct. Cl. 1969); Hugoton Production Company v. United States, 315 F.2d 868, 871 (Ct. Cl. 1963); McCord v. Granger, 201 F.2d 103, 106 (3d Cir. 1952); Pacific Nat. Bank v. Commissioner, 91 F.2d 103, 105 (9th Cir. 1937).)

For nearly 20 years, respondent has consistently taken the position that a value for property used but not owned or rented should be included in the property factor "so as to effectuate an equitable apportionment of the taxpayer's income." (Comments, supra.) This position has been part of appellant's formal regulations since the first regulations under UDITPA were promulgated and is now found in regulation 25137, subdivision (b)(1)(B).

Respondent, however, appears to contend that, regardless of the **fact** that this regulation is **specifically** addressed to the precise **issue raised** here, it is not bound to follow that regulation because it has been promulgated pursuant to section 251.37. Respondent is correct in asserting that special treatment under that **section** is allowed only when exceptional circumstances are present, i.e., the normal allocation and apportionment methods of UDITPA do not fairly represent the extent of the taxpayer's business activity in this state, and that the burden of showing **such** exceptional circumstances rests on the party seeking relief under section 25137.

However, respondent has determined **that in** a number of situations, the standard UDITPA methods do not appropriately reflect the extent of taxpayers' business activity in this state and has issued regulations under section 25137 setting forth the methods which it requires taxpayers to use in those situations. (Cal. Admin. Code, tit. 18, reg. 25137, subd. (b).) Respondent's determinations of these special **situations**, it must be assumed, were based on careful consideration and a conscious decision that, in these situations, the taxpayer's business activities were not fairly reflected by use of the standard formula. -(See Appeal of The O.K. Earl Corporation, supra.)

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Regulation 25137, subdivision (b), provides special ~~rules~~ which respondent has established with respect to the property factor. Subdivision (b)(1)(B) of that regulation deals precisely with the issue of property owned by others and used by the taxpayer at no charge. By issuing that regulation, which reaffirms the position respondent has publicly taken for almost 20 years, respondent has **effectively conceded** that where property owned by others is used by the taxpayer at no charge, a value for that property must be included in the property factor in order to fairly reflect the extent of the taxpayer's business activity in this state. The Franchise Tax **Board's** disregard of this regulation flies in the face of the principle that an agency's regulations bind the taxpayer and the agency equally. A taxpayer has the right to rely on the regulations of the taxing agency, and that agency should not be allowed to ignore its own regulation simply **because to** apply it in a particular case would be disadvantageous. (Mutual Savings Life Insurance Co. v. United States, 488 F.2d 1142, 1145-1146 (5th Cir. 1974).)

Although we have consistently held that the party requesting use of a special formula bears the burden of showing that exceptional circumstances exist, that requirement seems an empty exercise when the parties agree that exceptional **circumstances** exist. Appellant has stated that exceptional circumstances exist because it was impossible **for it** to own or rent the facilities and because of the nature of its use of the facilities, which entailed essentially all the attributes of ownership or rental except for title or a lease. Respondent, by its specific regulation on the subject pursuant to section 25137, must be considered to have implicitly agreed that this circumstance is exceptional and requires a special formula.

UDITPA's stated purpose was "to make uniform the law of those states which enact it." (Rev. & Tax. Code, § 25138.) We have required that the party seeking relief under section 25137 bear the burden of proving that exceptional circumstances exist in order to ensure that UDITPA would be applied as uniformly as possible. (Appeal of New York Football Giants, Inc., supra.) We do not believe that our holding in this case **does** violence to that principle. Respondent's regulation is one of the uniform regulations promulgated by the Multistate Tax Commission for use under UDITPA by the states which adopt it. (MTC Reg. **IV.18.(b)(2).**) We must assume that other UDITPA states have also adopted this regulation. Appellant

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points out that in an audit conducted by the Multistate Tax Commission for several of **its member** states covering the same years as those now on appeal, a reasonable rental rate for the government-owned facilities was included in the property factor and that similar treatment was accorded in independent audits by other member states. Although respondent has stated that these audits are "of no consequence as California was not a party to the audit" (emphasis in original) (Resp. **Br.** at 18-19), we find them to be of significance as showing that uniformity will be promoted by requiring the Franchise Tax Board to apply its regulation as other UDITPA states have done.

The Franchise **Tax Board** has not argued that regulation 25137(b)(1)(B) is invalid, that the property was not used in appellant's unitary business, or that the value assigned to the property by appellant was incorrect or unreasonable. Respondent, therefore, must include the value of the government-owned facilities in the denominator of the property factor.

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ORDER :

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise' Tax Board on the protest of Union Carbide Corporation against proposed assessments of additional franchise tax in the amounts of \$105,470.95, \$145,913.96, and \$256,482.31 for the income years 1971, 1972, and 1973, respectively, be and the same is hereby reversed as to the property factor issue discussed in the preceding opinion,' and sustained in all other respects.

Done at Sacramento, California, this 5th day
of April , 1984, by the State Board of Equalization,
with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Bennett
and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Ernest J. Dfonenburq, Jr,</u>	Member.
<u>William M. Bennett</u>	, Member
<u>Walter Harvey*</u>	, Member
	Member

*For Kenneth Cory, per Government Code section 7.9